

RESEARCH CREDIT DENIED ABSENT PROOF OF QUALIFIED EXPENSES IN BASE YEAR.

JUN. 21, 1995

Research Inc. v. U.S.

MEMORANDUM AND ORDER

Lindquist & Vennum, Kurtis A. Greenley, Minneapolis, MN appeared for and on behalf of Plaintiff.

Office of the United States Attorney, Minneapolis, MN and United States Department of Justice, Tax Division, Thomas V. Linguanti, Washington, D.C. appeared for and on behalf of Defendant.

INTRODUCTION

This is a corporate tax credit case involving the claims by the plaintiff Research, Inc. ("taxpayer") that it is entitled to certain research and development credits based on expenses that it paid or incurred during the tax year ending September 30, 1985.¹ This matter came on for hearing before the Honorable Michael J. Davis on December 7, 1995 [sic] upon defendant's motion for summary judgment pursuant to Fed. R. C. P. 56. For the reasons set out below, the motion of the United States is granted.

BACKGROUND

The taxpayer is in the business of designing, manufacturing and selling control instrumentation and heating devices. The taxpayer manufactures and sells a standard line of products, and several special systems projects. The special systems projects generally involve the design and construction of prototype systems which are built to meet the specialized needs and requirements of the customer. In developing both lines of products, the taxpayer incurs expenses that may qualify for the research and development tax credit provided for under Section 30 of the Internal Revenue Code, 26 U.S.C. section 30 (1985).

In its 1985 federal corporation tax return, taxpayer claimed that it had paid or incurred "qualified research expenses" in the amount of \$1,881,143 for work on its standard

product line. This figure was used by the taxpayer to claim the Section 30 tax credit. Before 1985, taxpayer had claimed only those expenses related to its standard product line. In 1985, however, taxpayer decided that some of the expenditures incurred in relation to its special systems projects ("unique systems") constituted additional qualified research expenses. Taxpayer then filed an amended return claiming an additional \$1,667,717 in qualified research expenses for 1985; such additional research expenditures would have qualified the taxpayer for an additional \$413,972 in research credit.

In the tax years 1982, 1983 and 1984 taxpayer claimed, respectively, \$1,426,165, \$1,772,137 and \$1,857,538 as qualified research expenses, all of which was attributable to its standard product line. The average of its qualified research expenses for the three years (or its base period research expense) was \$1,685,280.

Taxpayer's 1985 return was audited in 1988 and the Government refused to allow the taxpayer to adjust its qualified research expenses for any of the base period years because those years were closed. See, 26 U.S.C. section 6511. During a 1990 audit of taxpayer's 1985 amended return, the Government, however, suggested that the qualified research expenses allowed for the base period years should be greater than had been allowed because of the taxpayers failure to quantify the amounts of qualified research expenses attributable to its unique systems. The taxpayer, however, has destroyed the relevant documentation of its qualified research expenses for 1982, 1983 and 1984 or is otherwise unable to produce the required documentation. Moreover, the period for claiming an overpayment of taxes is set at three years.

The taxpayer commenced this lawsuit in an effort to obtain a refund of \$404,237 paid as a result of the dispute about whether it was entitled to an additional research credit for its fiscal year ending September 30, 1985. The \$404,237 is predicated upon a hypothecated upward adjustment of \$396,801 to the base period expense figure arrived at by the Government's Examiner. The Government's calculation was based on a "sales ratio" calculated by the examiner; there is, however, no basis in law or fact for the upward adjustment. The Government now moves for summary judgment, alleging that the taxpayer is not entitled to any additional refund; indeed, the government asserts that because the taxpayer is unable to accurately document its base year expenses, the taxpayer is not entitled to the research credit at all.

DISCUSSION

A. Standard for Summary Judgment

Under Federal Rule of Civil Procedure 56, a moving party is entitled to summary judgment if the evidence shows that "there is no genuine issue as to any material fact and that the moving party is entitled to judgment as a matter of law." *Celotex Corp. v. Catrett*, 477 U.S. 317, 322 (1986). The moving party bears the initial burden of establishing the nonexistence of a genuine issue of material fact. *Id.* at 323; *City of Mt. Pleasant, Iowa v. Assoc. Elec. Co-op.*, 838 F.2d 268, 273 (8th Cir. 1988). Once it meets that burden, the non-moving party may not then "rest upon the mere allegations or denials of his pleading, but . . . must set forth specific facts showing that there is a genuine issue for trial." *Anderson v. Liberty Lobby, Inc.*, 477 U.S. 242, 249 (1986). If, based upon the evidence, a reasonable jury could not return a verdict for the nonmoving party, summary judgment is appropriate. *Id.* at 248.

B. The Research Credit, 26 U.S.C. section 30 (1985) ²

Section 30 of the Internal Revenue Code, in 1985, provided in relevant part, as follows:

(a) General Rule. -- There shall be allowed as a credit against the tax imposed by this chapter for the taxable year an amount equal to 25 percent of the excess (if any) of --

- (1) the qualified research expenses for the taxable year, over
- (2) the base period research expenses.

* * *

The base period research expense is defined by Section 30(c) is defined [sic] as follows:

(c) Base Period Research Expenses. -- for purposes of this section --

- (1) The term "base period research expenses" means the average of the qualified research expenses for each year in the base period.
- (2) Base period. --

(A) In general. -- For purposes of this subsection, the term "base period" means the 3 taxable years immediately preceding the taxable year for which the determination is being made.

By the plain terms of the statute, then, the taxpayer must show: 1) the amount of its qualified research expenses in the current, or determination, year; 2) the amount of its qualified research expenses for each of the three years preceding the determination year; and, 3) that the determination year's qualified research expenses increased from the average of the preceding three years qualified expenses.

Deductions and tax credits are matters of legislative grace and do not "turn upon general equitable considerations." *Mercantile Bank & Trust Co. v. United States*, 441 F.2d 364, 366 (8th Cir. 1971). The burden is on a taxpayer asserting a claim for a deduction to prove that his claim fits clearly within the scope of a specific deduction section. The taxpayer must show that he is in compliance with every requirement of the applicable statute. *Alsobrook v. United States*, 431 F. Supp. 1122, 1126 (E.D. Ark. 1977), *aff'd*, 566 F.2d 628 (8th Cir. 1977), citing *New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440 (1934).

In a tax refund suit, the burden is upon the claimant to show that the Government has money which belongs to the taxpayer. *United States v. Pfister*, 205 F.2d 538, 542 (8th Cir. 1953), quoting *Lewis v. Reynolds*, 284 U.S. 281, 283 (1932). In order to prevail in this matter, the taxpayer must show that the IRS was wrong in its initial determination and that facts exist from which a proper determination of liability can be made. *Roybark v. United States*, 104 F. Supp. 759, 762 (S.D. Cal. 1952), *aff'd* 218 F.2d 164 (9th Cir. 1954).

The position of the Government in this matter is that the taxpayer cannot accurately delineate the amounts expended and, therefore, the taxpayer cannot qualify for the credit. The Government's reasoning is as follows: The taxpayer claimed as qualified research expenses only those expenses related to its standard line of products. In 1985, however, the taxpayer sought to claim as qualified expenses those expenses attributable to both its standard and unique lines of products. The taxpayer, however, did not adjust its base period expenses to reflect its expenditures on its unique product line and, further, admits that it cannot do so.

The Government points out that the language and intent of Section 30 effects a credit to the taxpayer only for INCREASING expenditures over the base period expenses. The Government asserts that where the taxpayer cannot accurately delineate the base period amounts attributable to both its standard and unique lines of products, it is simply not possible that it can qualify for the credit because there is no indicia of the amount of increase involved. In short, in the absence of some evidence that the amounts of qualified

research expenditures attributable to both lines of its products are an [sic] accurate, the taxpayer is barred from claiming the credit.

The taxpayer makes several points in response to the Government's position. First, the taxpayer points out that there is no authority, either statutory or in the case law for the retroactive adjustment of the base period expense. The taxpayer is correct, but the point made is irrelevant. The thrust of the government's position here is misapprehended by the taxpayer; the Government concedes that there is no authoritative basis for a recomputation of the base period years, but asserts that recomputation is not the issue. The primary argument of the Government does not evidence a concern with the readjustment of the base period expense so much as evidencing a concern with an accurate accounting of the expenses attributable to the base period expense; ultimately, the government asserts that, at all times relevant to this proceeding, the taxpayer has failed to produce such an accurate accounting and, therefore, never qualified for the credit under Section 30. That being so and the taxpayer concedes that it is, the taxpayer's position is untenable. The court agrees.

The taxpayer here bears the burden of proving its qualification for the credit. *Helvering v. Taylor*, 293 U.S. 507 (1935); *Welch v. Helvering*, 290 U.S. 111 (1939). In order to meet its burden, the taxpayer must be able to prove the correct amount of its base period research expenses. The taxpayer, however, claimed its expenses related to the development of its unique systems as qualified research expenses for the first time in 1985, although it had been engaged in the development of the systems prior to 1985; specifically, it had engaged in developing unique systems in each of the base years. That being so, the taxpayer was required to show the amount of qualified research expenses it paid in connection with the development of both its unique and standard lines. Without such an accounting, the taxpayer cannot show either initial qualification or the required increase in the average expenditure over the prior three years. That failing is dispositive in this case.

The language of Section 30 is clear and there is no need for resort to analogous case law or the unpublished and non binding private rulings of the Internal Revenue Service. The review in this matter is *de novo*. *Ruth v. United States*, 823 F.2d 1091 (7th Cir. 1987). The taxpayer must show the amount of its qualified research expenses in 1985 as well as its qualified research expenses for 1982- 1984 (the base period years), inclusive, and the amount by which 1985's qualified research expenses exceeded the average for the base period years qualified research expenses. If the taxpayer cannot make those showings, the taxpayer does not qualify for the credit. As Justice Holmes observed some 75 years ago,

"Men must turn square corners when they deal with the Government." *Rock Island, A. & L.R. Co v. United States*, 254 U.S. 141, 143 (1920). This case is one in which the corners were plainly required to be squared and all the formalities complied with. That the taxpayer did not then do so and cannot now do so does not require the court to grant the relief requested as a measure of its justice. Accordingly, the motion of defendant United States is granted.

CONCLUSION

Based upon the foregoing and all the files, records and proceedings herein, IT IS HEREBY ORDERED THAT:

1. Defendant's motion for summary judgment is GRANTED; and,
2. Defendant's Complaint is DISMISSED WITH PREJUDICE.

LET JUDGMENT BE ENTERED ACCORDINGLY.

Dated: June 21, 1995

Michael J. Davis, Judge
United States District Court

FOOTNOTES

¹ Taxpayer, as a corporation, operates on a fiscal year beginning October 1 and ending the following year on September 30. Thus, all references to the tax year 1985 refer to plaintiff's fiscal year.

² The research credit is now codified at 26 U.S.C. section 41. The problem presented by this case has been resolved by a 1989 amendment to the Code:

(4) consistent treatment of expenses required

(A) Notwithstanding whether the period for filing a claim for a credit or a refund has expired for any taxable year taken into account in determining the fixed-based percentage, the qualified research expenses taken into account in computing such percentage shall be determined on a basis consistent with the determination of qualified research expenses for the credit year.

26 U.S.C. section 41(c)(4)(A). The amendment applies to tax years beginning after 1989.

END OF FOOTNOTES